IN THE

Supreme Court of the United States

October Term, 1945.

No. 56

KIRBY PETROLEUM COMPANY,
Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent,

On Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

MOTION FOR LEAVE TO FILE AMICI CURIAE BRIEF AND BRIEF OF AMICI CURIAE.

CULLEN R. LISKOW,
NORMAN F. ANDERSON,
ELIAS R. KAUFMAN,
W. W. THOMPSON,
Amici Curiae.

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MOTION FOR LEAVE TO FILE AMICI CURIAE BRIEF.

TO THE HONORABLE COURT:

Cullen R. Liskow, attorney at law residing at Lake Charles, Louisiana, and duly admitted to practice before this Court, respectfully petitions the Court for leave to file, in the above entitled cause, *amici curiae* brief.

In support thereof, he says that he, with Norman F. Anderson, Elias R. Kaufman, W. W. Thompson, also attorneys at law residing at Lake Charles, Louisiana, is attorney for the petitioner in *Burton-Sutton Oil Company,*

Incorporated vs. Commissioner of Internal Revenue, Docket No. 361 of the present term of this Court which is now pending on application for certiorari to review a decision of the United States Circuit Court of Appeals for the Fifth Circuit. The issue in that case is the exclusion from gross income of net profits payments made by the petitioner to its transferor. The same basic principal is involved in the above entitled cause and also in *Commissioner of Internal Revenue vs. Anna Vickers Crawford,* No. 197, of the present term, where the specific issue is the allowance of depletion in respect of net profits payments. The Government agrees that the ultimate decision in the *Kirby* case may be decisive of the exclusion issue in docket No. 361.

Copies of this motion, together with the brief, have been handed to the attorneys for petitioner and respondent, and their written consent for the filing of the accompanying brief is attached hereto.

Respectfully submitted,

.................................,
CULLEN R. LISKOW,
Weber Building,
Lake Charles, Louisiana.

Of Counsel:

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NORMAN F. ANDERSON,

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ELIAS R. KAUFMAN,

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W. W. THOMPSON.

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On Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

CONSENT IS GRANTED FOR THE FILING OF THE ACCOMPANYING BRIEF OF AMICI CURIAE.

..............................,
HOMER L. BRUCE,
Attorney for Petitioner.

..............................,
HAROLD JUDSON,
Acting Solicitor General.

IN THE

SUPREME COURT OF THE UNITED STATES.

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COMMISSIONER OF INTERNAL REVENUE,

Respondent,

BRIEF OF AMICI CURIAE.

I.

THE OPINIONS OF THE COURTS BELOW.

The opinion of the Tax Court (R. 10) is reported in 2 T. C. 1258, and that of the Circuit Court of Appeals (R. 38) in 148 F. 2d 80.

II.

JURISDICTION.

Jurisdiction of this cause is conferred upon this Honorable Court by Judicial Code, Section 240, as amended; United States Code, Title 28, Section 347.

The judgment of the Circuit Court of Appeals was entered March 5, 1945. (R. 50.)

III.

STATEMENT OF THE CASE.

In the interest of brevity, no statement of the case will be made as it has been fully covered in brief of petitioner and respondent.

IV.

QUESTION PRESENTED.

Whether a net profits payment to be made throughout the term of the lease constitutes an economic depletable interest in oil and gas in place.

V.

STATUTES INVOLVED.

The applicable provisions of the statutes involved are set forth in an appendix, *infra* p. 18.

VI.

SPECIFICATION OF ERROR.

The Circuit Court of Appeals erred in holding that petitioner was not entitled to the depletion allowance on the amount received by it under the provisions of its contract that it was to receive 20% of the net profits arising

from the operation of oil and gas wells located on its property.

ARGUMENT.

Summary of Argument.

Point A.

The tax consequences to be given to oil net profits payments which are to be paid throughout the term of a lease is before this Court as an original proposition.

Point B.

The lessor has an economic interest in the oil and gas in place to the extent that it is entitled to share the net profits of the lessee and is entitled to an allowance for depletion.

Point A.

In the ordinary pattern of provisions for net profits payments in oil and gas lease deals, the participation is from the moment of discovery until the complete exhaustion of the deposit, or throughout the term of the lease. Since the person entitled to such payments must depend solely upon the production for the recovery of his capital investment and continues to receive that return from all oil produced during the commercial life of the deposit, he is just as vitally interested in the mineral deposit as a

producer. Conversely, the producer derives no benefit from the net profit he is required to pay to his lessor. Thus it seemed logical that the respective parties should be taxed only upon their respective shares of income and that they should each be given an allowance for depletion in order to permit them to have a recovery of their respective capital investments when the mineral deposit was finally exhausted. It is significant that, prior to the year 1941, the Government recognized these tax consequences.

The new and the present position of the Commissioner is set out in G. C. M. 22730, 1941-1 C. B. 214, which clearly states that it rests solely upon the Treasury's analysis of this Court's decisions in *Helvering vs. O'Donnell*, 303 U. S. 370, *Helvering vs. Elbe Oil Land Development Co.*, 303 U. S. 372, and *Anderson vs. Helvering*, 310 U. S. 404.

The taxpayer in the *O'Donnell* case at no time owned any interest in the mineral deposit. He merely owned a part of the stock in a corporation which had oil properties and he sold his shares to a third person who agreed to acquire the corporation's oil properties and to pay for the shares, an amount equivalent to one third of the net profits that might be earned from operating the oil properties. The taxpayer there, as a stockholder, of course, had no investment in the oil and gas in place and it is obvious that no such investment was made by reason of a sale of corporate shares to one who was likewise without any capital investment in the mineral deposit. The taxpayer was denied depletion on the sums he received for the sale of his stock in the corporation but the result

would have been the same if the sale price had been measured by reference to gross production from the wells. This decision was so interpreted by the Court of Claims in *Haynes vs. U. S.*, 50 F. Supp. 238, where the stockholder was held entitled to treat the proceeds arising from the sale of his shares, which was measured by gross production of the oil properties, as from the sale of a capital asset. No application for certiorari was filed by the Government and the result is logical.

In the *Commissioner v. Elbe Oil Land Development Co.*, 303 U. S. 372, the taxpayer had owned the working interest but made an absolute sale for $2,000,000.00 plus the agreement of the purchaser to pay additional money in the amount of one third (1/3) of the net profits if, after the purchaser had reimbursed itself for the cost of acquisition and all subsequent development and operating costs and expenses, there were any profits. As this Court pointed out (page 374), the agreement there specifically provided:

> "It is the intention of the parties to this agreement that the full ownership, possession and control of all the properties * * * shall be vested in Honolulu (purchaser) and Elbe shall have no interest in or to the said properties * * *."

Accordingly, this Court held that after the execution of such a contract, the taxpayer had no further interest in the properties and was not entitled to an allowance for depletion upon the $2,000,000.00 on the theory that it represented a bonus.

This Court granted the Government's application for certiorari in the *Elbe* case because of an asserted conflict with the decision of the Fifth Circuit Court of Appeals in *Commissioner vs. Fleming*, 82 F. 2d 324 (see 303 U. S. 374). In that case, the taxpayer assigned leases for cash payments plus certain amounts to be payable out of a portion of the gross production from the wells and he was held entitled to depletion on the part of the income representing payments out of production but not on the cash payment. The question for decision in the *Elbe* case was not as to an allowance for depletion in respect of the so-called net profits payments there provided for, but was whether the provision for these payments, under that particular contract, supported the contention that the cash payments represented a bonus or advanced royalty. The result, therefore, would have been the same if the contract had involved fixed oil payments out of gross production.

Under the peculiar conditions of the contract there, in addition to making it plain that the assignor had no interest in the properties, the contract gave the assignor no immediate interest in the production from the wells. The taxpayer's interest in production was postponed until the remote time, if ever, when the producer's operations had given it a complete recovery of the $2,000,000.00 cost of acquisition and all other expenditures for development and operation. Whether that interest would ever actually accrue was highly speculative. These differences serve to distinguish that case from the ordinary net profits provisions where the payment is to be made throughout the term of the lease.

Anderson vs. Helvering, 310 U. S. 404, laid down the rule that an economic interest looks solely to production for the recovery of the capital. The question for decision there was whether a depletion allowance was to be made in respect of a fixed consideration to be paid out of either (1) a certain percentage of gross oil production, or (2) the assignee's sales of fee interests in land.

In view of the foregoing, it is believed that the Government's interpretation of these decisions is erroneous and that the question of the tax consequences to be given to oil net profits payments, which are to be paid throughout the term of a lease, is before this Court as an original proposition.

Point B.

The lessor has an economic interest in oil and gas in place to the extent that it is entitled to share the net profits of its lessee.

The distinction to be drawn is to be determined by the practical and economic consequences. *Lynch vs. Alworth-Stephens Co.*, 267 U. S. 365, 370, *Burnet vs. Harmel*, 287 U. S. 103, 111, *Palmer vs. Bender*, 287 U. S. 551, 557, *Thomas vs. Perkins*, 301 U. S. 655, 659, *Helvering vs. F. & R. Lazurus & Co.*, 308 U. S. 252, 255, *Helvering vs. Clifford*, 309 U. S. 331, 334. The practical results of net profits payments in oil and gas lease deals are perhaps best seen by consideration of the facts in the case of *Commissioner vs. Felix Oil Co.*, 144 F. 2d 776, where the Ninth Circuit Court of Appeals held that the taxpayer, a fee owner,

was entitled to an allowance for depletion in respect of a 50% share of its lessee's net profits arising from the extraction of oil. These payments were the sole benefit accruing to the lessor for permitting the lessee to produce oil from its land. If the court there had not allowed depletion, the taxpayer would have been left without any means of recovering its investment in the minerals, or it would have been required to account for the income as arising from the sale of the oil in place.

The tax consequences following income arising from the sale of natural resources in place and income arising out of the operation of natural resources are well settled. If the transaction constitutes a sale of the mineral in place, the taxpayer is not, of course, permitted to take depletion on the income received, but, by the same token, he may offset the amount received against his basis for the purpose of computing gain and may apply the capital gains provisions to the resulting profit depending, of course, upon the length of time that the property had been held by him. He may, likewise, become entitled to the limitation on surtax as provided in Section 105 I. R. C. in the event the transaction represents a sale of natural resources which he has discovered. On the other hand, if the transaction does not constitute an outright sale but represents a lease or other similar transaction by which the taxpayer retains an economic interest in the property, then the entire amount of the payment must be included in taxable income, but the taxpayer would then be entitled to depletion for recovery of his capital investment.

There seems to be no logical reason why a lessor, who is entitled to receive a share of the profits throughout the

term of the lease, should be required or permitted to treat the transaction as a sale of the natural resources in place. The theory underlying the allowance for depletion is that a gradual sale is made and the allowance represents the reduction in the reserve from which the product is taken. *U. S. v: Ludey*, 274 U. S. 295, 301. The capital gains provisions and limited surtax rates on sales of oil properties were not intended to cover lease deals which look to the working of the mineral deposit for income to be realized gradually over the life of the deposit, and according to the actual results obtained from operations. Thus, in *Burnet vs. Harmel*, 287 U. S. 103, 106, it was said:

> "It is an incident of every oil and gas lease, where production operations are carried on by the lessee, that the ownership of the oil and gas passes from the lessor to the lessee at some time and the lessor is compensated by the payments made by the lessee for the rights and privileges which he acquires under the lease. But notwithstanding this incidental transfer of ownership, it is evident that the taxation of the receipts of the lessor as income does not ordinarily produce the kind of hardship aimed at by the capital gains provision of the taxing act. Oil and gas may or may not be present in the leased premises, and may or may not be found by the lessee. If found, their abstraction from the soil is a time consuming operation and the payments made by the lessee to the lessor do not normally become payable as the result of a single transaction within the taxable year, as in the case of a sale of property.
>
> "Such operations with respect to a mine have been said to resemble a manufacturing business carried on

> by the use of the soil, to which the passing of title of the minerals is but an incident, rather than a sale of the land or of any interest in it or in its mineral content. *Stratton's Independence v. Howbert*, 231 U. S. 399, 414, 415, 58 L. Ed. 285, 291, 292, 34 S. Ct. 136; see *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503, 521, 61 L. ed. 460, 470, 37 S. Ct. 201."

The lessor who looks to net profits payments for the recovery of his capital investment is just as vitally interested in the oil and gas in place as the lessee-producer. Cf. *Lynch vs. Alworth-Stephens Co.*, 267 U. S. 365, where this Court held that the lessee had a depletable interest notwithstanding that title to the ore stood in the lessor, and said, at page 370:

> "Obviously, as the process goes on, this property interest of the lessee in the mines is lessened from year to year, as the owner's property interest in the same mines is likewise lessened. There is an exhaustion of property in the one case as in the other; and the extent of it, with the consequent deduction to be made, in each case, is to be arrived at in the same way."

Risk of loss of the deposit also marks an economic interest in the oil and gas in place. In *Palmer vs. Bender*, 287 U. S. 551, this Court, in determining who held an economic interest as between parties who, at least in substance, were sublessor and sublessee, said, at page 558:

> "Production and sale of the oil would result in its depletion and also in a return of capital investment to the parties according to their respective interests.

> The loss or destruction of the oil at any time from the date of the leases until complete extraction would have resulted in loss to the partnerships. Such an interest is, we think, included within the meaning and purpose of the statute permitting deductions in the case of oil and gas wells of a reasonable allowance for depletion according to the peculiar conditions in each case."

The oil and gas industry knows only three considerations running to landowners under leases, namely (1) delay rentals, (2) bonuses or advanced royalties, and (3) rents or royalties. Delay rentals are made for the purpose of securing additional time in which to utilize the land and are not for the actual privilege of producing minerals. A bonus is a sum of money paid by the lessee to the lessor in consideration for the execution of the lease as distinguished from the rent or royalty reserved by the lessor to be paid by the lessee throughout the term of the lease. Rents or royalties are marked by the fact that they are to be paid throughout the term of the lease.

The character of these payments is not affected by the manner in which they are to be paid. *Helvering vs. Twin Bell Oil Syndicate*, 293 U. S. 312, 321. This Court has held that it is not concerned with the motives which lead the taxpayer to be satisfied with the proceeds he receives. *Helvering vs. Mountain Producers Corporation*, 303 U. S. 376, 382.

The Government does not deny that the lessor's net profits interest is lessened as the process of production goes on, that risk of the loss or destruction of the mineral

deposit is *pro-tanto* with the lessor's net profits interest or that such transactions look solely to working the underlying minerals for income, but it characterizes such interests as being merely in the ability of the producer to earn net profits and to account and pay them over. If a net profits payment is an interest in the ability of the producer to make net profits, the interest of a lessor in a royalty payable in kind is similarly in the ability of the lessee to find and extract the minerals, and that has never been considered as a reason for denying an economic interest. The lessor's reliance upon the lessee to account and pay over cash has been held not to have extinguished the lessor's economic depletable interest. *Helvering vs. Twin Bell Oil Syndicate*, 293 U. S. 312.

The construction urged by the Government would, in effect, read into Section 114 (b)(3) I. R. C. additional words to correspond with the words added in italics:

> "In the case of oil and gas wells, the allowance for depletion under Section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties, *which are payable in kind or, if in cash, are measured by a fractional part of the gross proceeds from sales of oil and gas,* paid or incurred by the taxpayer in respect of the property."

The essential purpose of Section 23(m) is to equitably apportion the single depletion allowance between the lessor and the lessee, according to the peculiar conditions in each case. Rents or royalties are used in Section 114

(b)(3) in their ordinary and common sense. These provisions are in *pari materia.* *Helvering vs. Twin Bell Oil Syndicate*, 293 U. S. 312, 320.

Payments arising out of the extraction of the oil to be made by the lessee to the lessor throughout the term of the lease for the privilege of producing minerals are rents or royalties in the commonly accepted meaning of those terms. The statutory provisions of (1) computation of gains on sales of assets allowing immediate deduction of the entire cost or other basis, (2) preferential treatment of gains from sales of capital assets, and (3) limited tax rates on sales of discovered oil properties were not intended to embrace lease deals which look solely to the working of a mineral deposit for income to be realized gradually over the life of the deposit and according to the actual results obtained from the producing operations.

To the extent that a lessor shares the net profits arising from the extraction of the minerals, his interests are lessened as production takes place, he assumes the risk of loss or destruction of the deposit, and he has a corresponding economic interest in the minerals in place.

The amount taxable to the lessor in respect of a net profits payment is the sum received or accrued during the taxable year and percentage depletion is allowable on such gross income. *Helvering vs. Mountain Producers Corporation*, 303 U. S. 376 and *Spalding vs. U. S.*, 97 F. 2d 697.

Provisions for net profits payments have been utilized by landowners who desire to participate in the economic

gains actually realized from the production of their minerals and, also by small independent producers who have sought to overcome their comparative lack of capital by working properties blocked up by the major units of the oil industry. There is nothing to indicate that there were any administrative difficulties in the method recognized prior to 1941. It is believed that the Government's present position, if sustained, will certainly result in many undue tax hardships and tax preferences which, in turn, will hinder landowners and independent producers in their efforts to secure a participation in the actual gains derived from severance of minerals.

CONCLUSION.

It is respectfully submitted that the judgment of the Fifth Circuit Court of Appeals should be reversed and that of the Tax Court of the United States be affirmed.

Respectfully submitted,

CULLEN R. LISKOW,
NORMAN F. ANDERSON,
ELIAS R. KAUFMAN,
W. W. THOMPSON,
Amici Curiae.

APPENDIX.

Internal Revenue Code:

Sec. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * *

(m) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * *

(26 U. S. C. 1940 ed., Sec. 23.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * * *

(b) Basis for Depletion.—

* * * * * *

(3) Percentage Depletion for Oil and Gas Wells.—In the case of oil and gas wells the allowance for depletion under Section 23(m) shall be 27½ per cen-

tum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under Section 23(m) be less than it would be if computed without reference to this paragraph.

* * * * * *

(26 U. S. C. 1940 ed., Sec. 114.)

SUPREME COURT OF THE UNITED STATES.

Nos. 56 and 197.—October Term, 1945.

Kirby Petroleum Company, Petitioner, 56 *vs* Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.
Commissioner of Internal Revenue, Petitioner, 197 *vs.* Anna Vickers Crawford.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

[January 28, 1946.]

Mr. Justice Reed delivered the opinion of the Court.

The writ of certiorari in *Kirby Petroleum Co.* v. *Commissioner* brings here for review the judgment of the Circuit Court of Appeals for the Fifth Circuit, 148 F. 2d 80, reversing the decision of the Tax Court, 2 T. C. 1258, which had sustained the taxpayer's position. The narrow issue is the deductibility under Sections 23(m) and 114(b)(3)[1] of the Internal Revenue Code of the depletion allowance of 27½ per centum of gross income from the

[1] Internal Revenue Code:

"Sec. 23. Deductions from Gross Income.

"In computing net income there shall be allowed as deductions:

. . . .

"(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. . . . In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. . . ."

"Sec. 114. Basis for Depreciation and Depletion.

. . . .

"(b) *Basis for Depletion.*—

. . . .

"(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property . . . ."

property during the taxable year, permitted by those sections from the taxpayer's gross income for 1940 from certain oil leases.

The taxpayer owned the fee simple title to certain Texas lands, except for a minor mineral interest which is not here involved. It leased the lands to two companies for the production of oil, gas and other minerals for a cash bonus, a royalty in the usual form and an agreement, executed contemporaneously with the lease and as part consideration therefor, that the taxpayer should receive twenty per cent of the net money profits realized by the lessees from their operations under the lease.

The same narrow issue is in *Commissioner* v. *Crawford*. In this latter case, the taxpayer owned an interest in fee in certain real estate in California. She, together with her co-owners, entered into several leases for portions of the property for the production of oil, gas and other minerals. For an understanding of the issues here presented, it is unnecessary to analyze the leases further than to say that they were given in consideration of bonuses, royalties in the usual form and additional payments from the net profits of the operation.[2] The Commissioner assessed a deficiency because of the denial of a claimed depletion allowance for 1938, 1939 and 1940. The Tax Court supported the taxpayer's position. The Circuit Court of Appeals affirmed. 148 F. 2d 776.

In both cases, the Commissioner concedes that the depletion allowance of Sections 23(m) and 114(b)(3) is applicable to the bonuses and royalties.[3] The statutory provisions are identical for all years. The 27½ per centum ~~of~~ Section 114(b)(3) was therefore properly deducted by the taxpayers from these bonuses and royalties. In each of these years there was also income to these taxpayers from the lease provisions for the lessors to share in the net profits from the oil extracted from the leased lands. The taxpayers claim the right to deduct the 27½ per cent depletion from these receipts also. These are the deductions which the Commissioner disallowed. On account of the conflicting decisions

lowed by

[2] The following clause of one lease will illustrate the type of arrangement which produced the additional payments:

"When, and as soon as the 'Income Credits' of said account shall exceed the 'Operating Charges' of the Lessee, the Lessor shall be entitled to a secondary and additional royalty, the amount thereof to be one-half of such difference between the 'Operating Charges' and 'Income Credits' of said account.'" The leases defined methods of computation.

[3] Burnet v. Harmel, 287 U. S. 103, 111; Palmer v. Bender, 287 U. S. 551, 557. See Anderson v. Helvering, 310 U. S. 404, 409.

of the Circuits in these cases on the point, certiorari was granted by us. — U. S. —; — U. S. —.

The present provisions for depletion allowances have been worked out so as to give the holder of an economic interest in the oil or other natural resource an allowance for depletion.[4] While there are income incidents to the utilization of natural resources, there is also an obvious exhaustion of the capital used to produce the income. In theory the aggregate sum allowed for depletion would equal the value of the natural resource at the time of its acquisition by the taxpayer, so that at the exhaustion of the resource the taxpayer would have recovered through depletion exactly his investment. The administrative difficulties in taxation of oil and gas production in view of the uncertainties of quantities and time of acquisition, that is at the purchase of the property or at the discovery of oil or gas, finally have brought Congress to the artibrary allowance of 27½ per cent now embodied in Section 114(b)(3).[5] Thus, the 27½ per cent is appropriated by the statute to the restoration of the taxpayer's capital and the rest of the proceeds of the natural asset becomes gross income. *Anderson* v. *Helvering*, 310 U. S. 404, 407-8. It follows from this theory that only a taxpayer with an economic interest in the asset, here the oil, is entitled to the depletion. *Palmer* v. *Bender*, 287 U. S. 551, 557; *Thomas* v. *Perkins*, 301 U. S. 655, 659. By this is meant only that under his contract he must look to the oil in place as the source of the return of his capital investment. The technical title to the oil in place is not important. Title in a case of a lease may depend upon the law of the state in which the deposit lies. *Burnet*

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[4] Treasury Regulation 103, Sec. 19.23(m)-1, as amended by T. D. 5413, 1944 Cum. Bull. 124, 129:

"Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest."

[5] For the background of the present provisions, see Helvering *v.* Twin Bell Oil Syndicate, 293 U. S. 312.

v. *Harmel*, 287 U. S. 103, 109-10. The test of the right to depletion is whether the taxpayer has a capital investment in the oil in place which is necessarily reduced as the oil is extracted. See *Anderson* v. *Helvering*, 310 U. S. 404, 407.

The taxpayers here involved were lessors. Under the leases and our previous decisions, these taxpayers had an economic interest, a capital investment, in so much of the extracted oil as was used by the lessee to pay to the taxpayers the royalties and bonuses. See note 3, *supra*. The taxpayer lessors were entitled to the depletion allowance on these royalties and bonuses whether they were paid to them in oil or cash, the proceeds of the oil. *Helvering* v. *Twin Bell Oil Syndicate*, 293 U. S. 312, 321.

If the additional payment in these leases had been a portion of the gross receipts from the sale of the oil extracted by the lessees instead of a portion of the net profits, there would have been no doubt as to the economic interest of the lessors in such oil. This would be an oil royalty. The lessors' economic interest in the oil is no less when their right is to share a net profit. As in *Thomas* v. *Perkins*, 301 U. S. 655, their only source of payment is from the net profit which the oil produces. In both situations the lessors' possibility of return depends upon oil extraction and ends with the exhaustion of the supply. Economic interest does not mean title to the oil in place but the possibility of profit from that economic interest dependent solely upon the extraction and sale of the oil.[6]

The depletion allowance, in the aggregate, is always the same amount, 27½ per centum of the "gross income from the property."[7] "In the case of leases the deductions shall be equitably apportioned between the lessor and lessee." Section 23(m). An equitable apportionment is obtained by excluding from the lessee's gross income from oil or gas produced from the property, *Helvering* v. *Twin Bell Oil Syndicate*, *supra*, 321; "an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property." Section 114(b)(3).[8] Such deductions become the

[6] While the reservation of royalties shows an economic interest in the oil necessary for the satisfaction of the royalties, such reservation would not show an economic interest in oil not necessary for the payment of the royalties. But see Estate of Jophet, 3 T. C. 86.

[7] Sec. 114(b)(3). The gross income refers only to oil and gas. Helvering v. Twin Bell Oil Syndicate, 293 U. S. 312, 320-21; Anderson v. Helvering, 310 U. S. 404, 408.

[8] See Helvering v. Twin Bell Oil Syndicate, 293 U. S. 312, 322.

gross income of the lessor. We think these taxpayers had an economic interest in the oil, sufficient to support depletion on the sums received as net profit.

If we assume that the only payment for the privilege of oil extraction made to the taxpayer lessors by the lessees was the portion of "net income" paid under the leases, it would be clear that such payment of "net income" would taxwise be rent or royalty paid by the lessees for the privilege of extraction. Since Section 114(b)(3) would require the lessees to deduct this rent or royalty from their gross incomes from the sale of oil from the property before taking the lessees' depletion, a gross receipt from oil sold, equal to the amount of the "net income" paid to the taxpayer lessors, would not be subject to depletion, unless the taxpayer lessors are permitted to apply depletion to this payment. This would be contrary to the purpose of the depletion statute, which is to allow to the lessor and lessee together a depletion of 27½ per cent of the gross sale price of the oil. On the other hand if depletion on the "net income" payments is allowed to the lessors, the lessees are allowed depletion on the gross income from oil sales less the net income payment and the entire allowable depletion is allocated between the lessors and lessees.

Reference is made to a sentence in *Anderson* v. *Helvering,* 310 U. S. 404, 409, as indicating that this Court had determined that "net profit" payments were not subject to depletion. It reads as follows:

> "A share in the net profits derived from development and operation, on the contrary, does not entitle the holder of such interest to a depletion allowance even though continued production is essential to the realization of such profits."

The *Anderson* case involved the taxability to the oil operator of the gross proceeds of the oil, which his contract for the purchase of the oil property required him to turn over to the seller as a means of satisfying a deferred payment for the property. As the deferred payment also had to be satisfied out of any sale of the fee simple title to the land, we held ~~the operator liable as a~~ purchaser because the seller was not "entirely dependent" upon the oil production for his purchase price. This gave the operator the benefit of the applicable depletion. Page 413. Only the reservation of an interest in the fee differentiated the *Anderson* case from *Thomas* v. *Perkins,* 301 U. S. 655, where deferred payment

in oil or its proceeds, payable only from production, was held subject to depletion when paid to the assignors.

The part just quoted from the *Anderson* case occurs in setting out the series of cases dealing with depletion. No net income was involved in the *Anderson* case. The statement was supported by the citation of *Helvering* v. *O'Donnell*, 303 U. S. 370, and *Helvering* v. *Elbe Oil Land Development Co.*, 303 U. S. 372. In the *O'Donnell* case, the taxpayer, who received the "net income" from an oil operation was a stranger to the lease, who had contracted for a share of its net profits as consideration for his stock in a corporation which was the owner of the lease. "The question is whether respondent had an interest, that is, a capital investment, in the oil and gas in place . . . . As a mere owner of shares in the San Gabriel Company, respondent had no such interest." Page 371. In the *Elbe Oil Land* case, there was a specific provision that consideration other than the "net profit" payment should result in "full ownership" to the buyer. The transaction which included the clause for "net profit" was a sale of all the right, title and interest in the property, which consisted of tangible personalty and drilling permits, agreements, and leases. This Court said the additional payment of a share of net profits did not qualify "in any way the effect of the transaction as an absolute sale." Page 375. Thus the *Anderson* case correctly stated that a share in "net profits," disassociated from an economic interest, does not entitle the holder to a depletion allowance. The facts of each transaction must be appraised to determine whether the transferor has made an absolute sale or has retained an economic interest—a capital investment.

In our view, the "net profit" payments in these cases flow directly from the taxpayers' economic interest in the oil and partake of the quality of rent rather than of a sale price. Therefore, the capital investment of the lessors is reduced by the extraction of the oil and the lessors should have depletion.

No. 56 is reversed.
No. 197 is affirmed.

Mr. Justice JACKSON took no part in the consideration or decision of these cases.

Mr. Justice DOUGLAS dissents.